STATEMENT TO THE
HOUSE COMMITTEE ON AGRICULTURE

NEW GENERATION COOPERATIVE STRUCTURES
AND THE FINANCIAL IMPLICATIONS
October 16, 2003

Chairman Goodlatte, Ranking Member Stenholm and distinguished members of the Committee, my name is Doug Sims. I am the chief executive officer of CoBank. I appreciate the opportunity to present testimony on business structures being used by new generation cooperatives and associations of producers. We commend the committee for holding this important hearing.

CoBank provides financial services to about 2,600 customers throughout the U.S. These customers are also CoBank's member-owners and include farmer-owned cooperatives, rural telecommunication companies, and rural electric cooperatives. We also provide financing to support the export of agricultural products. CoBank is part of the federally chartered Farm Credit System and we, like the vast majority of our customers, are a cooperative.

Farmer-owned cooperatives (referred to as associations of producers in the Farm Credit Act) have and continue to play a vitally important role in support of the American farmer. Moreover there is a new generation of cooperatives emerging in rural America that offer future opportunities to enhance farmer income.

For 70 years, CoBank has been the principal source of financing for the vast majority of farmer-owned cooperatives. The mission of serving the financial needs of farmer-owned cooperatives was assigned to us by this Committee and Congress, as set forth in the Farm Credit Act of 1971, as amended. I am here today because dated provisions of that Act will increasingly make it difficult for new generation farmer-owned cooperatives serving the interest of their farmer members to obtain financing from CoBank.

We estimate that CoBank provides about 80 percent of all credit extended to farmer owned cooperatives. We have customers in most rural counties and our cooperative members are often the cornerstone businesses in the communities the members of this committee represent. Our members serve a wide variety of farm interests from wheat and corn to rice and cotton to fruits, vegetables and dairy. While other large lenders may at times be an important source of credit to agricultural cooperatives, their interest in cooperative lending varies over time based on agricultural conditions and other business objectives. Congress has assigned us, as a cooperative owned by our customers, the mission to be there in good and bad economic times.

A USDA study entitled "The Impact of New Generation Cooperatives on Their Communities" found that farmer-owned cooperatives added $9.6 billion in net value to their members' products. Simple economics is the driving force for farmers to form businesses that provide a better chance for increased profits and of success in the marketplace.

My comments today will focus on finance related matters, but CoBank is also a member of the National Council of Farmer Cooperatives (NCFC) and strongly supports the recommendations made by NCFC at this hearing to strengthen the role of the Agricultural Cooperative Service in USDA, to support programs such as the value-added technical assistance grants and commodity purchase program and to address key tax issues that negatively impact cooperatives.

As we view the farmer-cooperative marketplace today and our role as a lender I would summarize a few key points:

1. Farmers and their cooperatives are changing as the marketplace and competition change and they aggressively seeking ways to enhance returns to farmers and address new challenges and opportunities. Being able to adjust quickly to changing market conditions is a critical factor in the success of farmer-owned cooperatives.

2. Increasingly, farmer-owned cooperatives are seeking new ways to return more income to their farmer-members through value-added enterprises and creative partnerships. We believe these new approaches when based on sound management and strong capitalization, should be encouraged and enhanced. Farmers often do not have the financial capacity to provide all the equity capital required for many value added enterprises.

3. To adjust to the marketplace, cooperatives are adopting new business models, which allow more flexibility in raising equity capital from non-producer sources, minimize tax liabilities and provide more operational flexibility. These new structures will often make the cooperative ineligible for CoBank financing.

4. As cooperatives and associations adjust to better serve their farmer-members, CoBank needs to support these farmer-controlled businesses without the current restrictions that are placed on cooperatives under the Farm Credit Act. State laws are changing to reflect the needs of cooperatives in today's economic environment and federal laws will also need to be modernized. Under the current situation, a farmer cooperative could be organized under the new Minnesota cooperative law, have farmer control on their board, and not be eligible for financing from CoBank, the bank established by Congress to serve farmer cooperatives.

5. Without action by Congress to update the cooperative eligibility provisions in the Farm Credit Act, CoBank will be unable to fulfill the mission it has for 70 years of providing credit to farmer-owned cooperatives.

The Economics of Farmer Ownership

Farmer-owned cooperatives are economic tools that exist for the purpose of providing farmers the means to improve their financial condition. This committee is well aware that most of the profits in the food system are generated after the farmer's product leaves the farm. A new generation of value added cooperatives offer farmers an opportunity to capture an increased part of the consumer food and fiber dollar. Cooperatives enable farmers to diversify their risk and earn greater returns through investments in our nation's processing, marketing and farm supply systems.

A study conducted by the Quentin Burdick Center for Cooperatives in North Dakota identified the benefits to farmers of value added cooperatives. These benefits include:

- Increase farm income and productivity,
- Reduce marketing risk,
- Increase market access,
- Increase member networking and market knowledge,
- Provide new services, and
- Increase membership share values or economic returns to farmer-owners.

We are optimistic about the changes in approaches that we see with many farmer-owned cooperatives. They are seeking new market opportunities to strengthen returns to farmers. More than ever we are seeing farmer boards and management working to evaluate the best business approach that will create more value back to the farmer. Part of the discussion on how to be successful evolves around the most appropriate business structure to attract investment, minimize tax liabilities and allow operational flexibility necessary for dealing with market changes.

The ethanol sector is one of the areas where business changes are being contemplated. CoBank currently finances about 20 ethanol facilities that operate in Minnesota, Iowa, Missouri, South Dakota and Nebraska. Financing for plants in Illinois and Kentucky have been approved. The financing for these companies involves over $200 million in credit and they produce about 620 million gallons of ethanol annually. On an ongoing basis, the return on equity to the farmer-owners of these plants is typically 10 to 15%

For the new ethanol plants being planned and even for some existing facilities, the farmer-owners are faced with a choice of selecting the most appropriate business structure that maintains farmer-control. In some cases the best business structure will not be eligible for CoBank financing. Attached to my statement is a letter from Howard Roe, Treasurer of Tall Corn Ethanol in Coon Rapids, Iowa. Tall Corn has recently altered their corporate structure to attract equity investment from non-members. As noted in the letter, capital was not available from farmer members. Tall Corn Ethanol has been able to attract outside investment and will continue to be controlled by farmers. As a result of their business change, Tall Corn is no longer eligible for credit through CoBank. Another example of a business that has changed their business structure to benefit their farmers and therefore will no longer be eligible for loans from CoBank is South Dakota Soybean Processors. SDSP has been a customer of CoBank's since their inception in 1996 (note attached letter).

This current situation is putting the farmer-owners of cooperatives in a very difficult position—by choosing the most advantageous corporate structure, the cooperative may be forced to forgo access to the lender created specifically to meet the needs of farmer-owned cooperatives.

The need to update lending eligibility provisions to reflect new business structures is not unique to CoBank and the Farm Credit Act. In 1999 USDA took action to allow the Rural Utility Service to finance Limited Liability Companies (LLC). In making this rule change (7 CFR Part 1735), USDA states, "This direct rule is part of an ongoing RUS project to modernize agency policies in order to provide borrowers with the flexibility they need to continue providing reliable telephone service at reasonable costs in rural areas."

Financial Needs of New Generation Cooperatives

As an organization dedicated to helping cooperatives thrive and maximizing benefits to farmers, we are excited about the new business models that farmer cooperatives are considering. These models will at times work to minimize farmer risk and obtain greater returns to their members. Farmers are attracted to them for a variety of reasons:

- Enhance Profits to Farmers—In the past, cooperatives often focused on being "not-for-profit" organizations. The purpose of the cooperative was to provide a market for the product, not a return for the owner. Most cooperatives today recognize that the business must be able to provide a reasonable return to farmers.

- Commodity Margins Are Razor Thin—The farmer who grows the wheat enjoys the smallest portion of the profit derived from the loaf of bread. By becoming an owner in the processing and marketing system, farmers can improve returns and diversify to reduce risks.

- Access to Capital From Multiple Sources—New companies often require a 40 to 50% level of equity. In today's economic environment, that level of capital is not available solely from farmers participating in the enterprise. Cooperatives with solid business plans and achievable profitability targets can attract outside non-member capital to supplement the farmer investment. Often times this investment can come from the non-farmers living in the rural community. Non-farmer investment does not mean the farmer class of owners must give up control or forgo operating on a cooperative basis.

- Tax Advantages of New Structures—The new cooperative structures may also have tax advantages that are generally available to limited liability companies—a key consideration for farmer owners. An example is self-employment taxes, which are paid on cooperative dividends, but not on LLC distributions.

While we are enthused about these new models, the committee needs to be aware of some of the realities facing cooperatives. As noted above, CoBank finances the vast majority of cooperatives including a high percentage of the smaller ones. Nationwide, there are fewer than 1,500 farmer-owned cooperatives with credit needs. CoBank considers it part of our mission to work with groups of farmers who are interested in establishing new cooperatives. The risks of new ventures are high and must be carefully considered. By bringing in outside equity capital, farmers share the risk with non-farmers. A farm cooperative business that adds value to a product rather than just passing it up the processing chain can bring diversity and profitability to a farmer's investment -- the opportunity to share that risk and reward with others is often a key indicator of success.

<u>Policy Implications</u>

Cooperatives are chartered under state laws and many states where cooperatives are prominent are on the verge of changing their laws to define a new generation of cooperatives. Minnesota and Wyoming already have changed their laws. Further a cooperative does not need to be located in these states to charter in Minnesota and Wyoming. Cooperatives physically located in other states can simply organize themselves under the Wyoming and Minnesota laws similar to the way in which many corporations organize under Delaware corporate laws. As a consequence, we believe that virtually no new cooperative will be chartered under the old statutory provisions that restrict the operation of farmer cooperatives. The key impediments of the old laws are outmoded dividend requirements and voting and ownership limitations for non-farmer members of the cooperative.

For CoBank, specific requirements that farmer-owned cooperative associations must meet in order to be eligible to borrow from the bank are spelled out in Section 3.8(a) of the Farm Credit Act. As noted, these traditional requirements are based on a cooperative model that may no longer be suitable for many farmer-owned cooperative enterprises. The specific reason that an association of farmers under a new business structure may no longer be eligible to borrow from CoBank varies by each case, but may include the following:

- Because of the need to attract outside investment, the traditional Farm Credit Act requirement that a cooperative either operate on a one-member one-vote basis or restrict dividends to 10% (or less if further limited by state law), may not be met as a separate investor group is established and the cooperative utilizes more flexible voting requirements. Attracting outside investment may be done to enhance operations, build new markets with value-added products, or to help a cooperative avoid asking hard-pressed farmer-members to make additional capital contributions.

- Because of the need to flexibly source some products fom producers other than members, the new cooperative entity may not meet the Farm Credit Act requirement that non-member business not exceed member business.

CoBank is recommending that Congress amend current law to ensure that these new generation cooperatives do not jeopardize their ability to borrow from CoBank as they structure themselves to compete in the marketplace. Key components of this proposal would:

- Authorize associations of producers that have both a producer and investor class of membership to be eligible for CoBank financing, provided that the producer class holds at least 50 percent of the voting control and operates on a cooperative basis.

- Permit agricultural cooperatives organized consistent with revised state cooperative laws to be eligible for CoBank financing.

- Allow cooperative customers that are adopting new business structures to continue to be eligible for CoBank financing as long as the customer maintains at least 50 percent farmer control or continues to be cooperative under state law.

- Provide that cooperatives that are existing CoBank customers, but which restructure in a manner that would make them ineligible for CoBank financing, can remain eligible for a five-year transition period while the cooperative establishes new lending relationships.

In today's financial environment there are very few lending institutions with the necessary scale, expertise – and most importantly – the desire to lead lending efforts to farmer-owned cooperatives. Nothing in these recommendations expands our scope of lending to new areas. These changes will allow us to continue to serve the same type of farmer-controlled businesses that we have served well for 70 years. Without this action, CoBank will not be able to meet its mission of serving farmer-owned cooperatives. The reality is that in many of the cooperative businesses that we finance, there are only three or four lenders that may be interested in considering the business because of the complexity and size of the loan. To eliminate the bank with the biggest and most consistent market share and the one with the greatest expertise does not make sense. Nor does it make sense to force an association of producers to use a traditional cooperative model in order to obtain financing from CoBank.

So that CoBank can continue to carry out our mission as established by Congress, we would appreciate the opportunity to work with you to update CoBank's eligibility requirements along the lines we have suggested for agricultural cooperatives. Without this legislation, farmers and the cooperatives they own will be denied access to CoBank as a source of financing as these new cooperative structures are employed.

This proposal has already received the endorsement of dozens of national, local and regional farm groups and cooperative organizations—including the American Farm Bureau Federation, Farm Credit Council and the National Council of Farmer Cooperatives. We encourage you to give this matter your most serious consideration.

Mr. Chairman, thank you for holding this important hearing. I appreciate the opportunity to provide this testimony and would be pleased to respond to any questions.